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APS

A subsidiary of Pinnacle West Capital Corporation

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Brian Brumfield
Supervisor
Regulation, Pricing & Administration

Tel. 602-250-2708
Fax 602-250-3003
e-mail Brian.Brumfield@aps.com

Mail Station 9708
PO Box 53999
Phoenix, Arizona 85072-3999

January 20, 2006

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix Arizona 85007

RE: APS Emergency Interim Rate Increase and Amendment to Decision 67744 Docket No. E-01345A-06-0009

Docket Control:

Attached please find the Supplemental Direct Testimony and attachments of APS witnesses Donald Brandt and Peter Ewen.

Should you have any questions please feel free to contact me.

Sincerely,

Brian Brumfield, Supervisor
Regulation, Pricing & Administration

Cc: Parties to Docket

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DIRECT TESTIMONY OF PETER M. EWEN

On Behalf of Arizona Public Service Company

Docket No. E-01345A-06-0009

January 20, 2006

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DIRECT TESTIMONY OF PETER M. EWEN
ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY
(Docket No. E-01345A-06-0009)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Peter M. Ewen. My business address is 400 N. 5th Street, Phoenix, Arizona, 85004.

Q. WHAT IS YOUR POSITION WITH ARIZONA PUBLIC SERVICE COMPANY?

A. I am Manager of the Revenue and Fuel Analysis and Forecasts Department for Arizona Public Service Company ("APS" or "Company"). In that role, I am responsible for preparing the Company's short-range and long-range forecasts of system peak demand and energy sales and projecting the optimal dispatch of available resources to minimize the cost of meeting those energy requirements.

Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. I received Bachelors and Masters degrees in Economics from Arizona State University in 1985 and 1988, respectively. I have analyzed and forecasted electric energy and demand growth since 1988, first as a Staff member of the Arizona Corporation Commission ("Commission") and, since 1990, as an employee for APS. I have specifically analyzed the actual dispatch of our generating units in combination with market purchases to serve native load demand since 1998, and assumed full responsibility for making the optimal dispatch and associated fuel cost projections in 2000. I was formerly President of the Arizona Economic Round Table, a group of Arizona-based economists that specialize in studying the Arizona economy, and I am still a member of that organization. I also serve on the Joint Legislative Budget Committee's Finance Advisory Committee. This consists of a group of state economists who advise the Joint Legislative Budget Committee staff on the adequacy of the economic projections underlying their state revenue projections.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony sets forth the basis for the Company's requested interim base rate level of fuel and purchased power expenses of 3.1904 ¢/kWh. This is the same amount as I will be testifying to in the Company's updated rate case filing on January 31, 2006 using the twelve-months-ending September 30, 2005 as the Test Year. The requested interim base rate associated with this level is 14% greater than the Company's current base rates authorized in Decision No. 67744 (April 7, 2005), and equates to an additional $299 million in annual revenue. The Company's current base rates include a base fuel rate of 2.0743¢/kWh. I also discuss the Company's hedging program and its impact on these expenses, which is a net benefit to customers of $169 million. Absent that benefit, the requested interim base fuel and purchased power rates would be 8% higher.

II. DISCUSSION

Q. WHAT ARE THE KEY TRENDS DRIVING THE INCREASE IN THE COMPANY'S BASE COST OF FUEL?

A. APS' base fuel recovery amount of 2.0743 ¢/kWh established in Decision No. 67744, which was based on 2003 cost levels, is not adequate to compensate for the fuel and purchased power market price changes since 2003. APS is therefore requesting an interim rate increase of $299 million in additional electric revenues to allow the Company to recover continued increases in fuel and purchased power expenses. This amount was calculated by comparing the amount currently recovered through base rates (2.0743¢/kWh) to the costs that the Company incurred during the twelve months ending September 30, 2005 (the "historical period") (2.701¢/kWh) as adjusted to reflect 2006 conditions the Company is expected to experience during 2006 (3.1904¢/kWh) to meet the needs of its customers. Attachment PME-1 shows these changes in fuel costs. My testimony focuses on the reasons for those increased costs.

The increasing costs that the Company is experiencing are the result of a number of factors, which are summarized in the following paragraphs.

- Incremental Sales Growth and Fuel Mix: APS has one of the fastest growing service territories in the country and growth is one of the dominant factors producing increased fuel and purchased power expenses. The Company's incremental sales attributable to growth must be met primarily with high-cost natural gas and purchased power (virtually all of which is derived from gas-fired generation). That incremental sales growth, therefore, is leading to a shift in the Company's fuel mix to a heavier emphasis on natural gas. This factor alone accounts for $147 million of the requested interim rates increase.
- Natural Gas Prices: Natural gas prices have increased dramatically since 2003 and, coupled with purchased power price increases, are responsible for a $330 million increase in the Company's base cost of fuel (prior to the results of our hedging program). The Company's current base fuel rate set in Decision No. 67744 incorporated natural gas prices of $5.78/MMBTU. During the historical period, natural gas prices jumped to

$7.20/MMBTU, an increase of 25%. At the close of the market on November 30, 2005, delivered natural gas prices for calendar year 2006 averaged $10.74/MMBTU, a further 49% increase over the historical period and 86% over the level included in the current base fuel rate. Attachment PME-4 shows the historical transaction prices for 2006 natural gas contracts at Henry Hub.

- Purchased Power Prices: Prices for purchased power (most of which comes from natural gas generation) also increased significantly over the same time periods. The base rate set in Decision No. 67744 incorporates a purchased power price of $43.37/MWh, while the average price incurred by the Company during the historical period was $57.50/MWh, a 33% increase. On November 30, 2005, purchased power prices were anticipated to average $87.56/MWh during 2006, an increase of 52% over the historical period and 102% over the level included in the current base fuel rate. Attachment PME-5 shows the historical transaction prices for 2006 on-peak power contracts at Palo Verde, and the similarity to the gas market is plainly evident.
- Coal Prices: Although the dramatic increase in prices for natural gas and purchased power, when combined with the significant growth that the Company is dealing with, represents the largest component of the requested interim rate increase, prices for coal resources also are increasing. Coal prices increased 13% between 2003 and the historical period and are projected to increase an additional 6% in 2006. Cumulatively, higher coal prices have raised the Company's base cost of fuel by $34 million.

- Hedging: As discussed above, coal prices, natural gas prices and power prices all increased during the historical period. APS's request would have been significantly higher absent the results of the Company's commodity hedging program. All of the price increases discussed above rolled together would have amounted to an increased fuel expense of approximately \$364 million — \$330 million for gas and power and \$34 million for coal. The Company, however, was able to reduce fuel expense by more than \$169 million through its hedging program. By the end of August 2005, the Company had hedged 85% of its 2006 gas and power requirements. The vast majority of these contracts are at prices significantly below recent market prices and, valued at November 30, 2005, will save the Company and its customers almost \$2.50/MMBTU on the effective gas price incurred in 2006.

The following table summarizes these results:

Incremental Sales Growth	\$ 147 million
Natural Gas and Power Prices	\$ 330 million
Coal Prices	\$ 34 million
Hedge Value	\$ (169) million
All Other Items	\$ (43) million
Total of All Changes	\$ 299 million

Attachment PME-1 quantifies the impact of these key factors on the Company's fuel cost trends. Attachment PME-2 shows graphically the differential in costs for the Company's various resources and the changes in those costs over time. One can plainly see the impact that a changing fuel mix toward natural gas and wholesale market purchases and rising prices across all fuel resources will have on the Company's costs. Attachment PME-3 provides the values of the key factors that contribute most to those costs.

In light of the above factors, it is easy to see why the Company has requested an increase in the Base Fuel Recovery Amount in Docket No. E-01345A-05-0816. I am proposing that the Base Fuel Recovery amount be set at 3.1904 ¢/kWh, subject to adjustment, if necessary, through the Company's pending rate case. That amount reflects expected 2006 fuel and purchased power prices and corresponding hedging results and includes a credit for anticipated off system sales margins and the effects of adding the Sundance units to the APS system.

Q. **PLEASE EXPLAIN THE METHODOLOGY YOU USED TO DEVELOP THE ADJUSTMENTS TO THE BASE FUEL RATE YOU DISCUSSED ABOVE.**

A. The method employed in calculating the new base fuel rate I propose above is identical to the method used to calculate the Company's current base fuel rate and accepted by the Commission in Decision No. 67744. The impacts of increased sales levels, higher fuel prices and other normalizing adjustments have been simulated using the Company's production cost simulation tool RTSim. This computer model replicates the dispatch of the APS system and is the primary fuel expense and off-system sales forecasting tool used by the Company in preparing its annual budgets, long range fuel forecasts, and near-term operational plans. The input factors I have used in both this docket and in Docket No. E-01345A-05-0816 are the same as or consistent with the expected levels in the Company's 2005 Long Range Forecast ("LRF") for the year 2006, the 2006 Sales Budget, with appropriate customer annualizations, and the November 30, 2005 forward curve for natural gas and power prices and the corresponding valuation of the Company's hedges. This approach is entirely consistent with the method used by the Company and accepted by the Commission for establishing the Company's Base Fuel Rate in Decision No. 67744.

Q. HOW DOES THE PRODUCTION COST SIMULATION MODEL CALCULATE THE AVERAGE FUEL AND PURCHASED POWER COST?

A. The model simulates the dispatch of the APS generating units on a daily and hourly basis. It takes into account the APS system load shape, fuel prices (including wholesale market prices for power) and characteristics of APS owned generating plants (such as heat rates, overhaul cycles, unplanned outage rates, start-up costs and ramp rates, among others), along with commitments for purchases and sales of power. The model also simulates necessary market purchases for those times when load exceeds generating capacity, and likewise simulates market sales during those times when the system is not fully utilized but generating units are economic (or "in-the-money").

The projected hourly dispatch of each of the units, along with the wholesale market purchases and sales, are priced out at the corresponding contract or market price projections included in the model. Fixed costs – those expenses that do not vary with the level of production – are then added to the model results. The result is the total expected fuel expense and off-system sales revenue consistent with the assumptions used in the model.

Q. HAVE YOU NORMALIZED POWER PLANT UNPLANNED OUTAGE TIME IN THIS PROCESS?

A. Yes. Attachment PME-6 shows the comparison of normalized unplanned outage time, expressed as EFOR, to the historical rates experienced by the Company's plants. This means, for example, that I have used an EFOR of 2.5% for the Palo Verde units rather than the actual 2005 EFOR of 8.8%.

III. CONCLUSION

Q. DO YOU HAVE ANY FINAL REMARKS?

A. The run up in natural gas and purchased power prices over the last several years has been well documented. Those increased prices are anticipated to persist into the future. Because the vast majority of the Company's incremental load growth is served by natural gas (either through the operation of the Company's own generating facilities or through purchased power), the Company's fuel expense has increased dramatically since 2003, the year used to set the base fuel amount currently in effect. Because these amounts clearly are necessary expenditures required to meet APS' customers' needs, the base fuel amount should be adjusted, on an interim basis, accordingly.

Q. DOES THIS CONCLUDE YOUR PREFILED DIRECT TESTIMONY IN THIS PROCEEDING?

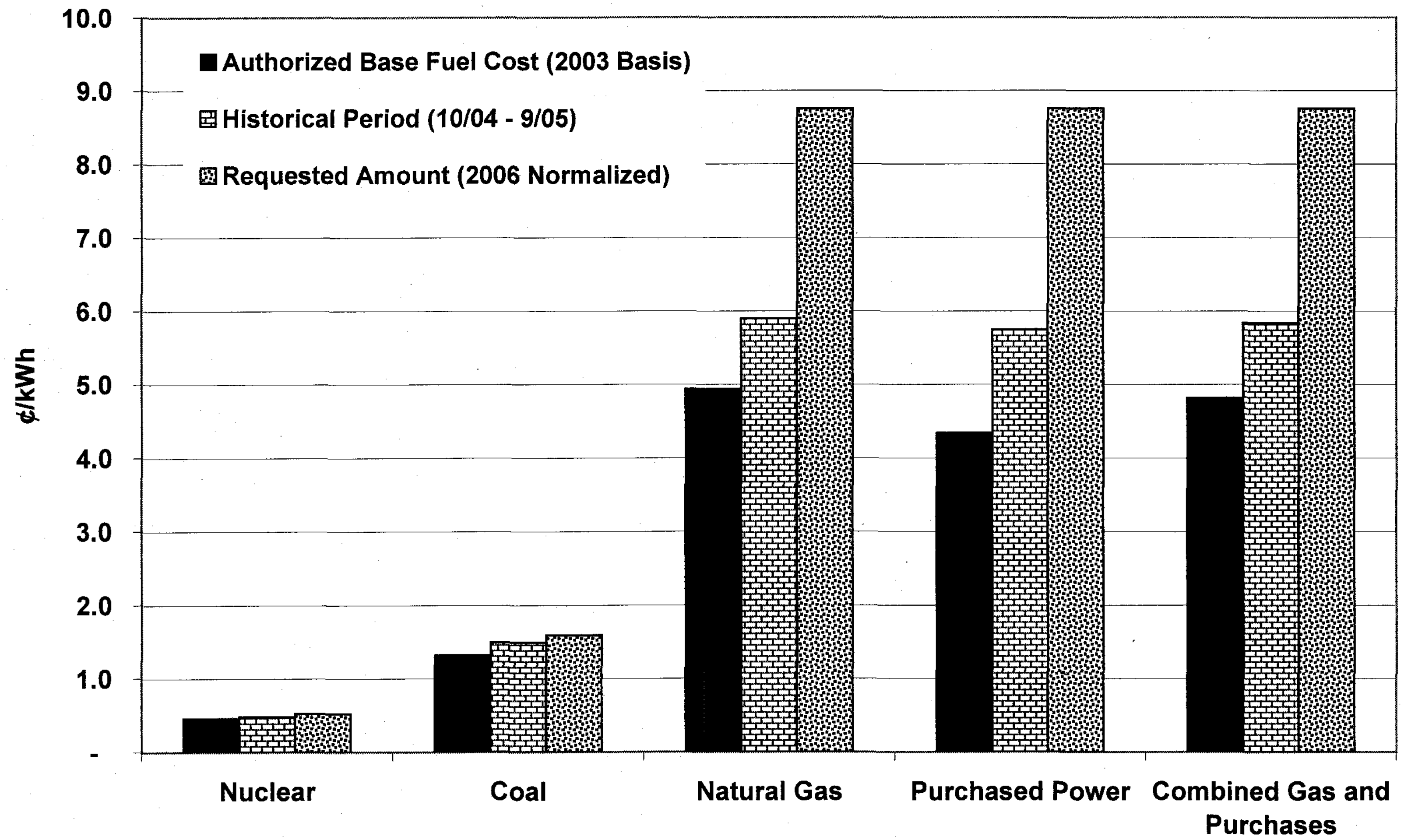
A. Yes.

ATTACHMENT PME-1

Arizona Public Service Company
Summary of Base Fuel Cost Changes

	Current Authorized Level (2003 Conditions)	Historical Period Level (12ME 9/30/05)	Historical Period vs. Current Authorized	Requested Level (2006 Conditions)	Requested vs. Historical Period	Requested vs. Current Authorized
Base Fuel Cost (¢/kWh)	2.0743	2.7010	0.6267	3.1904	0.4894	1.1161
Historical Period Normalized Sales (GWh)	26,759	26,759		26,759		
Base Fuel Expense ($000,000)	555.1	722.8	**167.7**	853.7	**131.0**	**298.7**
Reasons for Change ($000,000)						
Increased Share of Natural Gas, Market Purchased Power			59.5		87.5	147.1
Prices for Natural Gas, Purchased Power			94.0		235.6	329.6
Value of Gas and Power Hedge Contracts			(70.5)		(98.7)	(169.2)
Net Effective Price of Natural Gas, Purchased Power			23.5		136.9	160.4
Coal Average Fuel Cost			21.9		11.9	33.8
PWEC Bridge PPA			53.6		(53.6)	-
All Other			9.2		(51.7)	(42.5)
Total			**167.7**		**131.0**	**298.7**

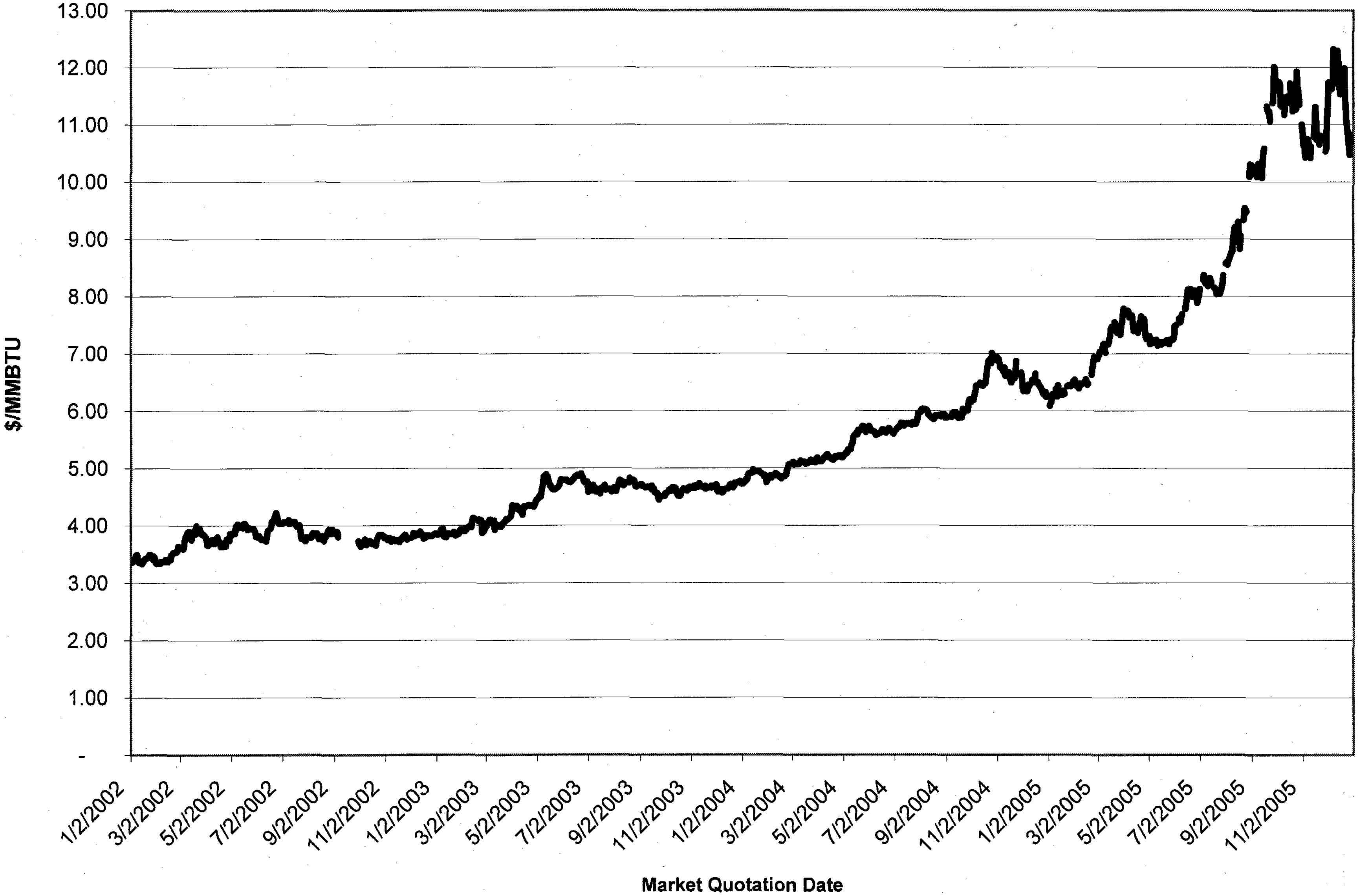
Average Fuel Cost by Type of Resource



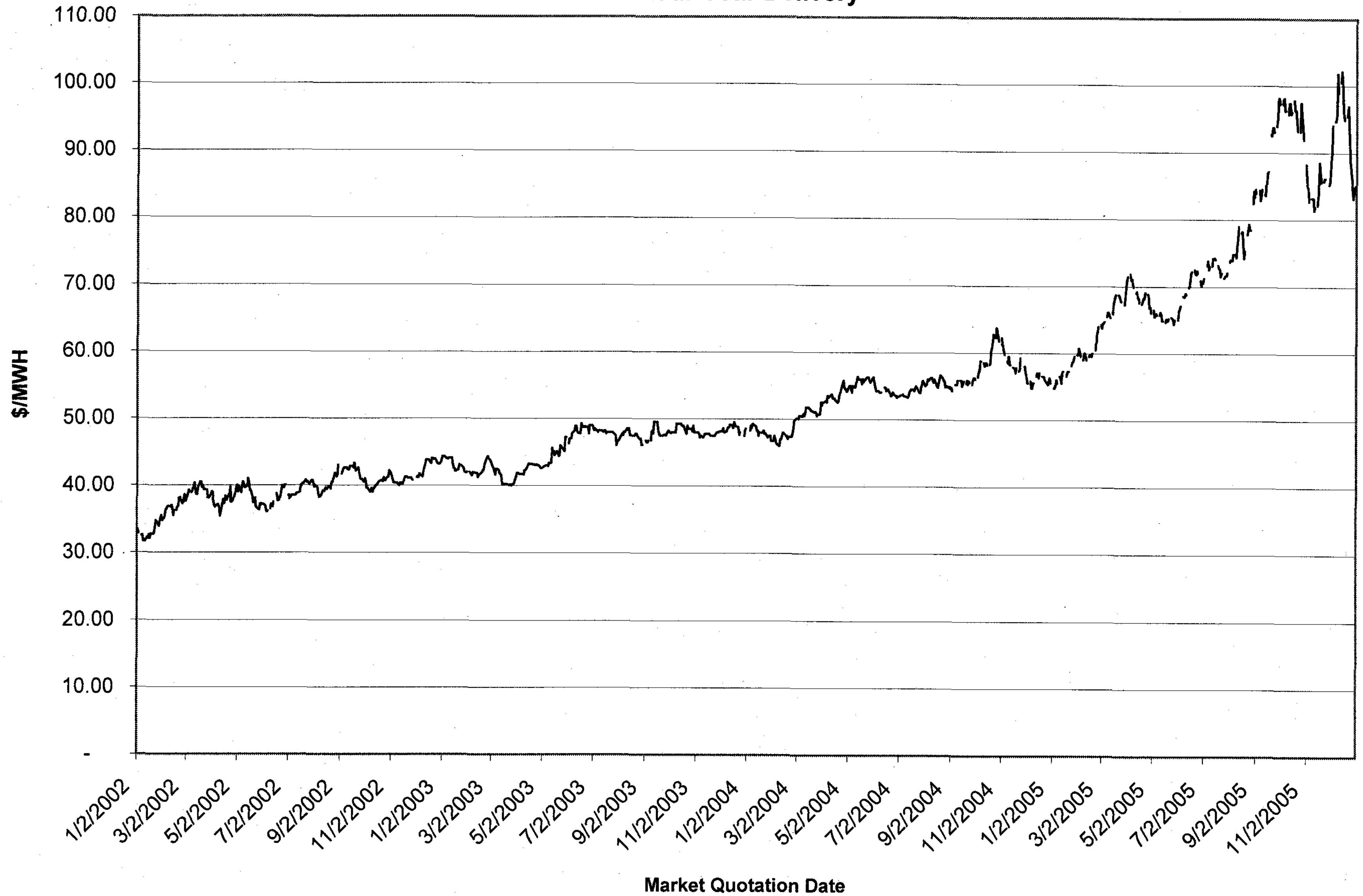
ARIZONA PUBLIC SERVICE COMPANY
SUMMARY OF KEY FACTORS IN INTERIM RATE REQUEST

	2003 Authorized	TME 9/30/2005	Requested 2006 Normalized
Gas and Purchased Power Share of Native Load Energy	22.4%	28.3%	28.6%
Gas Prices			
Delivered ($/mmbtu)	5.78	7.20	10.74
Hedge Value ($/mmbtu)	-	(1.68)	(2.48)
Effective Gas Price ($/mmbtu)	5.78	5.52	8.26
Power Prices			
Palo Verde On-Peak ($/MWh)	53.21	58.75	88.88
Average Purchase Cost ($/MWh)	43.37	57.50	87.56
Average Coal Cost ($/MWh)	13.19	14.96	15.91
Average Nuclear Cost ($/MWh)	4.58	4.81	5.24

Attachment PME-4
Historical Transaction Prices for Forward Natural Gas Contracts at Henry Hub
2006 Calendar Year Delivery



Attachment PME-5
Historical Transaction Prices for Forward On-Peak Power Contracts at Palo Verde
2006 Calendar Year Delivery



Arizona Public Service Company
Comparison of Historical EFOR to Normalized EFOR

	2001	2002	2003	2004	2005	5 Year Average	Normalized EFOR
Nuclear	1.3%	0.9%	2.4%	8.0%	8.8%	4.3%	2.5%
Four Corners	11.2%	10.8%	8.8%	7.0%	10.1%	9.6%	9.1%
Cholla	11.5%	5.0%	22.4%	2.6%	2.3%	8.8%	5.7%
Navajo	3.7%	3.2%	3.5%	2.1%	4.6%	3.4%	5.3%
West Phoenix CC1-3	5.3%	5.3%	5.3%	5.3%	7.0%	5.6%	7.0%
West Phoenix CC4		4.0%	1.5%	11.6%	36.3%	13.4%	7.0%
West Phoenix CC5			7.5%	11.7%	6.5%	8.6%	10.0%
Redhawk CC1		9.3%	1.5%	3.6%	3.8%	4.6%	7.5%
Redhawk CC2		22.7%	20.0%	12.0%	2.6%	14.3%	7.5%
Steam Plants	8.8%	8.4%	16.6%	24.5%	11.4%	13.9%	7.8%
Gas Turbines	8.9%	25.7%	54.2%	26.9%	33.3%	29.8%	11.1%
Saguaro CT3		12.8%	4.0%	1.8%	1.5%	5.0%	6.0%

DIRECT TESTIMONY OF DONALD E. BRANDT

On Behalf of Arizona Public Service Company

Docket No. E-01345A-06-0009

January 20, 2006

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DIRECT TESTIMONY OF DONALD E. BRANDT
ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY
(Docket No. E-01345A-06-0009)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Donald E. Brandt. I am Executive Vice President and Chief Financial Officer for both Pinnacle West Capital Corporation ("Pinnacle West") and Arizona Public Service Company ("APS" or "Company"). I am responsible for the finance, treasury, accounting, tax, investor relations, financial planning, and power marketing and trading functions at Pinnacle West and APS. My business address is 400 North 5th Street, Phoenix, Arizona, 85004.

Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. I received a Bachelor of Science degree in business administration with a major in accounting from St. Louis University in 1975. Before joining Pinnacle West and APS in 2003, I was Senior Vice President and Chief Financial Officer of Ameren Corporation, the parent company of the electric and gas utilities Union Electric Company (d/b/a AmerenUE) and Central Illinois Public Service Company (d/b/a AmerenCIPS).

Before joining Union Electric Company in 1983, I was a manager with Price Waterhouse where I provided audit and consulting services to public companies, with a concentration in the utility industry. I am a certified public accountant and a member of the American Institute of Certified Public Accountants and the Arizona Society of Certified Public Accountants.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony explains why the Company filed the Application for Emergency Interim Rate Increase and Interim Amendment to Decision No. 67744 ("Application"). I discuss the nature of the emergency that the Company is facing, describe the Company's current financial condition, and summarize recent actions taken by the various credit rating agencies with respect to APS's debt. I also address the consequences of failing to act on the Company's Application in a timely fashion.

II. SUMMARY

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. The Company confronts an emergency situation and critically needs timely action by the Arizona Corporation Commission ("Commission") permitting the Company to recover its prudently incurred fuel and purchased power costs. Without such action, the Company faces the prospect of a downgrade of its credit to non-investment ("junk") levels.

Recently, each of the three primary credit rating agencies took adverse actions with respect to APS. Standard & Poor's ("S&P") downgraded the Company to the lowest investment grade credit rating, BBB-, just one notch above a "Junk" bond credit rating, while Fitch, Inc. put the Company on "Rating Watch Negative," and Moody's Investor Service, Inc. ("Moody's") put the Company's debt ratings under review for possible downgrade. Should the Commission deny the Company's request for emergency interim rate relief, APS's credit ratings likely will be downgraded by these nationally recognized agencies to below investment grade even with approval of the pending Power Supply Adjustment ("PSA") surcharge and the implementation of the annual PSA adjustment on April 1, 2006. Should a downgrade occur, the Company would experience severely restricted access to the capital markets (both debt and equity) and commercial bank credit facilities, dramatically increased financing costs, and, consequently, decreased operational and financial flexibility.

The rapidly growing gap that exists today between the Company's funds from operations ("FFO") and its capital expenditures ("CapEx") significantly exceeds the shortfall that occurred during the construction of the Palo Verde Nuclear Generation Station ("PVNGS") when this Commission lasted granted APS interim rate relief. We must finance this shortfall in a financially prudent manner. If the Company's credit ratings fall below investment grade, the costs to customers to finance this gap increases dramatically.

III. APS'S FINANCIAL CONDITION AND CREDIT RATINGS

Q. DID YOU FILE AN AFFIDAVIT IN SUPPORT OF APS'S APPLICATION FOR EMERGENCY INTERIM RATE RELIEF?

A. Yes. That Affidavit, incorporated here by reference, is attached to my Direct Testimony as Attachment DEB-1. This Direct Testimony both supplements and makes current that Affidavit.

Q. ARE THE STATEMENTS MADE IN THAT AFFIDAVIT STILL TRUE TO THE BEST OF YOUR KNOWLEDGE?

A. Yes.

Q. WHAT IS THE EMERGENCY THAT THE COMPANY IS FACING?

A. The emergency the Company faces has a number of interrelated facets:

1. APS has experienced an unprecedented increase in its fuel and purchased power costs since the establishment of the base fuel rate in Decision No. 67744 and will continue to face significant further increases in those costs

during 2006 due to ongoing exogenous factors and fundamental shifts in the global energy markets.

2. Because these increases are not reflected in either base rates or in PSA rates, APS' cost deferrals totaled approximately $170 million by the end of 2005. Those cost deferrals will continue to increase in 2006 even if the Commission allows the implementation of the annual adjustment to the PSA on April 1, 2006 and approves the pending PSA surcharge – accumulating to approximately $285 million by December 31, 2006.

3. The continued imbalance between fuel costs and cost recovery has weakened the Company's key financial indicators to the point where APS has been downgraded by one major rating agency (S&P) to the lowest investment-grade rating and put on negative watch for a downgrade by the other two (Moody's and Fitch). All three have indicated further credit downgrades should the Commission not address fuel cost recovery in a manner that promises to reverse the downward trend in the Company's financial indicators. Absent interim rate relief to address the growing undercollection of fuel costs, APS will likely suffer further downgrading by S&P and the other rating agencies to non-investment grade or "junk bond" status for the first time in its over 100-year history of service to the public in Arizona. As such, APS would rank among the least creditworthy, non-bankrupt utilities in the United States.

4. A credit rating agency downgrade of APS to non-investment grade would increase interest expense in 2006 by at least $10,000,000 to $15,000,000. This increase in annual interest expense would continue to rise inexorably to between $115,000,000 and $230,000,000 by 2015. Cumulatively, over the ten-year period ended 2015, the increased interest expense would

aggregate between $625,000,000 and $1,200,000,000, depending upon the general level of interest rates and access to the capital markets by non-investment grade issuers. This market has shown much greater volatility than the investment grade sector. Our customers would eventually bear these massive costs.

5. Credit limitations imposed on APS as a result of a further downgrading will increase the cost of both fuel acquisition and purchased power, thus ultimately burdening APS customers with costs that could be avoided by timely and positive Commission action. Restraints on credit also consume already scarce cash resources needed to fund important and critical infrastructure improvements and expansion. The consequences of a credit downgrade include higher collateral requirements, reduced liquidity as certain venders declined to enter into contracts with APS, and onerous cash constraining prepayment requirements for power, gas, gas transportation, and coal.

6. History has demonstrated that once a company experiences an important credit downgrade, it takes years of sustained positive regulatory action to reverse the situation. Unfortunately, the high cost debt incurred and alluded to above will continue to exert a negative influence on the Company's financial and cash situation, until such time as APS can call, refund or retire it.

7. Without an interim raising of the $776.2 million "cap," APS will be unable to defer some $65 million in 2006 presumptively prudent fuel costs, thus potentially affecting its ability to ever recover such sums.

8. Based on published reports, the pending APS general rate case will apparently not be decided within a reasonable time, by which the

Company means within time to prevent the above circumstances from happening. And even a 100% favorable outcome from that proceeding likely would not be sufficient to result in an upgrade of APS or undo the loss to APS during 2006 resulting from the $776.2 million "cap." The financial markets pay close attention to the comments of all regulatory bodies. Currently, they do not see any reasonable prospect of a prompt adjudication of the Company's general rate case filed in November, 2005. In its December 21, 2005 publication explaining the ratings downgrade, S&P stated: "Recent public statements by the ACC suggest spring 2007 may be the earliest a decision could be expected."

We urge the Commission to re-examine the difficult current situation in light of all the relevant facts and to balance the many interests in a manner that avoids causing "serious damage" to APS and its customers.

We only ask APS customers to pay for the fuel costs necessary to serve them, without profit or mark up. Ultimately, they will bear the price, whether paid in the form of interim rates, PSA charges and/or higher base rates resulting from Docket E-01345-05-0816. Should the Commission later determine that APS imprudently incurred such costs, our customers will receive a refund or other appropriate adjustment.

As customary in a regulated environment, customers receive full protection from a grant of interim relief later found unwarranted or inappropriate by the Commission's periodic review of the prudence of the Company's actions. We urge the Commission, in effect, to protect the customers from the higher costs that will accompany the Company's descent into "junk bond" status. We believe that the prevention of such a credit downgrade and the attendant adverse consequences serves the best interest of all the parties involved. None of us want to attempt the even more difficult time-consuming and costly attempt to repair damaged credit ratings.

Q. HAVE THERE BEEN ANY DEVELOPMENTS SINCE THE DATE OF YOUR AFFIDAVIT?

A. Yes. Since the filing of my Affidavit in Support of the Application, S&P issued an additional Research Summary regarding APS on January 6, 2006, and both Moody's and Fitch have taken negative ratings actions regarding the Company.

Q. DO YOU BELIEVE THOSE ACTIONS PROVIDE FURTHER SUPPORT FOR THE COMPANY'S REQUEST FOR EMERGENCY INTERIM RATE RELIEF?

A. Yes. All of the rating agencies recognize the urgency of the Company's need for recovery and have taken negative ratings actions in light of that concern. The Company incurred fuel and purchased power costs in a prudent and commercially responsible manner to serve customers. Without prompt and positive action by the Commission, the Company faces almost certain downgrade to "junk" status. Should that occur, APS and its customers face a long and costly road ahead due to steeply increased financing costs and other negative ramifications as set forth in my Affidavit.

Q. PLEASE PROVIDE ADDITIONAL DETAIL ON S&P'S JANUARY 6, 2006 RESEARCH SUMMARY.

A. On January 6, 2006, S&P issued a research summary in light of the Administrative Law Judge's Recommended Opinion and Order in the Company's pending PSA surcharge application. S&P noted that the Company's continued accumulation of deferred fuel and purchased power costs is "making the need for rate relief increasingly critical for the credit ratings of the company. . . ." [S&P Research Summary, January 6, 2006, at 1.] S&P also reiterated its decision to lower the Company's credit rating to BBB- based on "concerns that the regulatory process in Arizona is not providing the company timely recovery of fuel and purchased power costs" and noted the Company's "mounting deferral problem that is severely straining cash flows." [Id.] Finally, S&P stated that in the absence of prompt action by the Commission "to address APS' need for rate relief in light of steadily increasing fuel and purchased power deferrals . . . an adverse rating action or a change in the outlook is likely." [Id. at 2]

Q. WHAT ACTION HAS MOODY'S TAKEN REGARDING THE COMPANY'S RATING?

A. On January 10, 2006, Moody's placed the ratings of APS under review for possible downgrade, noting as follows:

> Moody's Investors Service placed the long-term [debt] ratings of Pinnacle West Capital Corporation (Pinnacle: Baa2, senior unsecured) and its subsidiaries Arizona Public Service Company (APS: Baa1, senior unsecured) and PVNGS II Funding Corp. Inc. (PVNGS II: Baa1, senior secured lease obligation bonds) under review for possible downgrade. . . .
>
> The rating review follows a recommendation of an Arizona administrative law judge that APS's application for a special rate surcharge be denied. The review is prompted by deterioration in the company's current and projected financial metrics as a result of increased fuel and purchased power costs that the company has not been able to recover on a timely basis.
>
> The review will focus on the outcomes of the various rate requests that APS has filed or is expected to file with Arizona Corporation Commission (ACC). . . .
>
> APS and Pinnacle's financial strength are highly dependent upon timely implementation of cost recovery mechanisms. . . .
>
> Beyond 2006, supportive regulatory treatment remains key to the company's ability to maintain financial strength in light of significant needs for capital investment to serve a growing service territory. . . ,

> An assessment of likely regulatory outcomes will be a significant factor in concluding the review for downgrade. The ratings of APS and Pinnacle are likely to be downgraded unless there are clear signals that APS will receive timely and full recovery of its increased costs such that we would expect their credit metrics to return to levels commensurate with those of similarly rated utility companies. [Moody's Rating Action, January 10, 2006.]

Q. PLEASE EXPLAIN WHAT ACTION FITCH TOOK ON THE COMPANY'S CREDIT RATING.

A. Fitch placed the Company's long-term credit ratings on Rating Watch Negative on January 6, 2006, reflecting "the likelihood of lower ratings . . . if the Arizona Corporation Commission (ACC) adopts the administrative law judge's (ALJ) proposed decision in APS' pending power supply adjustor (PSA) surcharge proceeding." [Fitch Ratings Release, January 6, 2006.] Fitch went on to state:

> In Fitch's view, the regulatory uncertainty and prospect of further delay to the recovery of prudently incurred power supply costs is a threat to APS and PNW's creditworthiness, especially in light of the company's high and growing reliance on natural gas and purchase power. [Id.]

Q. ARE THERE SIMILARITIES BETWEEN THESE THREE MOST RECENT STATEMENTS BY THE RATING AGENCIES?

A. Yes. All three of the rating agencies point directly to the Company's increasingly critical need to recover in a timely manner fuel and purchased power costs prudently incurred to serve its customers as the basis for their negative actions. APS seeks to address this critically important issue through its Application.

Q. DID YOU ATTEND THE PROCEDURAL CONFERENCE HELD ON JANUARY 12, 2006 IN THIS DOCKET?

A. Yes.

Q. DID YOU HEAR THE DISCUSSION REGARDING THE COMPANY'S FINANCIAL SITUATION TODAY AS COMPARED TO ITS FINANCIAL SITUATION DURING THE CONSTRUCTION OF PVNGS IN THE 1980'S?

A. Yes. While referencing the January 1984 APS interim rate increase, Commissioner Mayes referenced page 4 of Decision No. 53909 (January 30, 1984) and noted that one of the reasons the Commission granted that increase "was that by June of 1984, APS's internal generation of funds will be practically zero if not negative." (Transcript, page 20.) Consistent with Commissioner Mayes' comment, page 4 of Decision No. 53909 contains the following finding of fact:

> 14. By June of 1984, APS's internal generation of funds will be practically zero, if not negative.

Q. TO WHAT EXTENT IS THAT REFERENCE RELEVANT TO THIS PROCEEDING?

A. While Decision No. 53909 uses the term "internal generation of funds," if one reads the 1983 testimony of the Company's financial witnesses, particularly the testimony of Henry B. Sargent, Jr. and Paul A. Williams and related exhibits, one would find that the term "internal generation of funds" was defined as "internal generation of funds as a percentage of capital expenditures (excluding AFUDC)."

The discussion of the 1984 order at last week's procedural conference may have left the Commission with an erroneous impression regarding the Company's current financial situation. Certain statements, made during the procedural conference may have led the Commission to infer that the Company's current situation is not as critical as the last time APS sought and received interim rate relief. On the contrary, I believe that the Company's current financial situation is actually worse than that of the 1980s. During those difficult times, the Company experienced a credit downgrading and ultimately received an emergency rate increase. The following chart shows that APS faces a significant shortfall between its FFO and its CapEx needs that at least equals, if not exceeds the financial obstacles it faced in the 1980s:

APS FFO vs. CapEx ($M)

	1983	1984[1]	1985	2005[2]	2006[2]
Funds from operations	$ 223.0	$ 300.9	$ 375.4	$ 459.6	$ 520.5
CapEx	359.7	328.0	445.9	810.5	648.5
FFO less CapEx	(136.7)	(27.1)	(70.5)	(350.9)	(128.0)
FFO as a % of CapEx	62.0%	91.7%	84.2%	56.7%	80.3%

Q. PLEASE EXPLAIN WHAT THE ABOVE CHART SHOWS.

A. In a nutshell, the APS FFO vs. CapEx chart clearly shows how the Company's weak cash flow will drive credit ratings toward junk status. As reflected in the chart, the Company's current FFO shortfall exceeds that of the 1980's when the Company received its last emergency rate increase. APS will have no alternative but to issue ever increasing amounts of costly debt to finance that shortfall. The combination of weak cash flow and the resulting need for additional debt will result in a weaker FFO/Debt ratio, which likely will cause a downgrade of the Company to non-investment ("junk") grade. As I discuss throughout my testimony, downgrades inevitably increase borrowing costs, lower the value of common equity and contribute to higher costs to customers.

Q. DO YOU HAVE ANY FINAL COMMENTS?

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[1] Interim Rates were approved for APS effective February 1, 1984 in Decision No. 53909 (January 30, 1984). Those interim rates were made permanent in Decision No. 54204 (October 12, 1984), which also granted an additional rate increase. Also in Decision No. 54247 (November 28, 1984), the Commission approved an increase in electric rates, which became effective in early 1985. During the same time period, the Commission also granted APS gas rate increases in Decisions Nos. 54056 (June 1, 1984) and 54183 (October 1, 1984)

[2] Figures for 2005 and 2006 reflect projected amounts. Figures for 2006 presume the Company receives the PSA Adjustor effective April 1, 2006, as well as PSA Surcharges effective in February and November 2006.

A. Yes. The Company will need cost effective and efficient access to the capital markets to issue more than $1 billion of debt to fund the necessary projects that constitute the Company's substantial capital expenditure budget over the next several years. Without the interim rate relief requested in the Application, the Company's credit ratings likely will be further reduced to non-investment grade, which will lead to dramatically increased financing costs to APS and, ultimately, its customers. Once they downgrade a company, the rating agencies are reluctant to upgrade that company on the basis of one or two positive rate cases. The rating agencies likely will require supportive Commission actions over a sustained period of time before considering returning the Company to investment grade if a downgrade has occurred.

As an oversight regulatory body, the Commission understands that with the growth of economic activity, industry and population in our service territory, we have an obligation to the public to maintain our financial integrity and infrastructure. Reasonably priced, dependable electric power attracts commerce and people to our state, and hence, maintains and enhances Arizona's economic strength.

Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

EXHIBIT A

BEFORE THE
ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AN EMERGENCY INTERIM RATE INCREASE AND FOR AN INTERIM AMENDMENT TO DECISION No. 67744	DOCKET NO. E-01345A-06-____

AFFIDAVIT OF DONALD E. BRANDT

General

1. My name is Donald E. Brandt. I am Executive Vice President and Chief Financial Officer for both Pinnacle West Capital Corporation ("Pinnacle West") and Arizona Public Service Company ("APS" or "Company"). I am responsible for the finance, treasury, accounting, tax, investor relations, financial planning, and power marketing and trading functions at Pinnacle West and APS.

2. The assertions of fact contained within the Application of the Company for emergency interim rate relief and for an interim lifting of the $776.2 million "cap" on purchased power and fuel cost recovery are true and correct to my knowledge and belief.

3. The purpose of this affidavit also is to testify, from my personal experience and involvement as the Chief Financial Officer, regarding the financial basis for the interim rate relief request, Standard & Poor's ("S&P") recent downgrade of the APS's credit ratings, the likelihood of further adverse actions by the credit rating agencies, and the impacts on APS and its customers of such actions. If the emergency interim rate relief is approved, it should prevent a further downgrade of the Company's credit ratings. If the emergency interim rate relief requested by the Company is denied, APS's credit ratings likely will be downgraded to below investment grade (i.e., non-investment grade or "junk"). Such an action will have an immediate and dramatic adverse impact on the

Company and its customers in terms of severely restricted access to financing, dramatically increased financing costs, and decreased operational flexibility.

Specific Background Facts

4. In Decision No. 67744 (April 7, 2005), the Arizona Corporation Commission ("Commission") granted APS a Power Supply Adjustment Mechanism ("PSA").

5. The credit rating agencies viewed the approval of the PSA as one of the critical elements of Decision No. 67744. They viewed the existence of the PSA as reducing the Company's financial risk because they recognized that the PSA was designed to permit APS to recover its fuel and purchased power costs incurred to serve customers. On the other hand, the rating agencies were disappointed that the PSA approved in Decision No. 67744 has certain significant limitations, which S&P referred to as "structural weaknesses." *S&P Research Update: Outlook on PWCC and APS's Ratings to Stable on Resolution of Rate Case* (April 1, 2005).

6. The rating agencies based their analysis of Decision No. 67744 on the belief that the Commission would implement the PSA in a manner that would allow the Company to recover its fuel and purchased power costs in a timely manner. The agencies noted, however, that if APS were to lose the PSA or fail to receive timely and fair recovery of its fuel and purchased power costs, APS's financial profile would be significantly weakened. As S&P recently noted:

> A relatively weak power supply adjustment mechanism, in combination with rapidly escalating and volatile gas prices, as well as the potential for a protracted surcharge proceeding, could cause deterioration in financial performance which, year to date, has been sub par for the rating.

S&P, Research Summary, Arizona Public Service Co. (October 4, 2005).

7. As I discuss further below, on December 21, 2005, Standard & Poor's ("S&P") downgraded APS's credit ratings from BBB to BBB-, the absolute lowest

investment grade credit rating. S&P noted, however, that its decision to maintain APS's new, lower credit ratings at "stable" was based on an "expectation that the ACC will resolve at least a portion of APS's increasing deferred power costs in January 2006." Standard & Poor's, *Research Update: Pinnacle West Capital's, Arizona Public Service's Ratings Lowered to 'BBB-'; Outlook Stable* (December 21, 2005). With the recent issuance of the Recommended Opinion and Order in Docket No. E-01345A-05-0526, I fully expect S&P and Moody's Investor Services ("Moody's") to take negative action on APS's credit ratings unless there is some other substantial form of timely rate relief. Once such negative credit rating actions are taken, it would take dramatic and sustained regulatory support to reverse them.

8. S&P recently noted that the Company's "need for fuel cost recovery is becoming critical." S&P, Bulletin: No Immediate Rating Change from Draft Decision on Arizona Public Svc. Cost Recovery (January 5, 2006). That need is further highlighted by the fact that due to the recent dramatic increases in fuel prices, the Company will reach the $776.2 million "cap" on fuel and purchased power costs well before the Commission will rule on the Company's pending rate case application. Without the lifting of the "cap" the Company's financial situation clearly will worsen even further.

APS's Financial Condition and Credit Ratings

9. Each year, APS must access the capital markets to issue debt to fund a portion of the costs of the Company's infrastructure additions and improvements required to meet customer needs, including new and upgraded transmission and distribution facilities, generation plant improvements, new environmental control systems, and other service facilities. The Company's capital expenditure ("CAPX") budget for 2006 is approximately $650 million. Over the years 2006 through 2009, the CAPX budget is more than $3 billion. Over those same years, the Company will need to access the capital markets to issue over $1 billion of debt to fund the projects that make up that budget,

even assuming its pending rate request in Docket No. E-01345A-05-0816 is granted in full and on schedule before year end.

10. The cost that APS must pay for the debt it must issue to fund capital expenditures is based on the credit ratings it is assigned. Every decrease in APS's credit rating increases the cost to the Company, and its customers, for the debt that must be issued. Those costs increase dramatically when a company's credit rating falls to a non-investment ("junk") grade level. For that reason, both APS and its customers have a strong interest in maintaining investment grade credit ratings.

11. Credit rating agencies base their credit ratings of companies on certain financial criteria that measure a company's financial health, performance and risk. The rating agencies have established financial metrics as guidelines for determining a credit rating. The key financial metric examined by the credit rating agencies is the ratio of Funds from Operations to debt ("FFO/Debt"). FFO/Debt measures the sufficiency of a company's cash flow to service both debt interest and debt principal over time.

12. As a result of the Company's continued inability to collect in a timely manner a significant portion of its fuel and purchased power costs, an imbalance has developed between cash revenue and cash expense. Due to this deterioration in cash flow, the FFO/Debt ratio continues to worsen.

13. To maintain a BBB credit rating, S&P expects a company to maintain a FFO/Debt of 15% to 22% for a Business Profile 5 and 18% to 28% for a Business Profile 6. The Business Profile assigned to a company reflects S&P's assessment of the business environment in which the company operates, on a scale where 1 represents the least risky environment from an investment perspective and 10 the most risky.

14. On December 21, 2005, S&P changed APS to a Business Profile 6, reflecting its assessment that APS faces increased regulatory risk. S&P also downgraded APS's debt as follows:

	From	To
Senior Unsecured Debt	BBB	BBB-
Secured Lease Obligation	BBB	BBB-
Commercial Paper	A-2	A-3
Ratings Outlook	Stable	Stable

15. S&P expressed concern "that the Arizona Corporation Commission (ACC) is not expeditiously addressing APS's growing fuel and purchased-power cost deferrals…." S&P, *Research Update: Pinnacle West Capital's, Arizona Public Service's Ratings Lowered to 'BBB-'; Outlook Stable* (December 21, 2005). Put simply, S&P downgraded APS because of the substantial cash flow deficiency caused by the Company's inability to timely recover its rapidly escalating fuel and purchased power costs. Moreover, the "stable" ratings outlook was conditioned on S&P's expectation that the Commission would take steps to resolve some of the Company's deferred power costs in January 2006 in a positive manner, as well as take other steps to shore up the Company's financial metrics.

16. Without the approval of the emergency interim rate relief requested by the Company, APS's financial condition will suffer severe and continued deterioration, likely resulting in a credit ratings downgrade to the non-investment grade level. If the interim rate relief is denied, APS's FFO/Debt remains in the BB "junk bond" range at 16.0% at the end of 2006, even if the $80 million surcharge is granted in the first quarter of 2006 and the PSA adjustor takes place on April 1, 2006. If the $80 million surcharge and the April 1, 2006 PSA adjustment are not granted, the Company's FFO/Debt declines even further to end 2006 at 13.3%, which is almost at the single B level.

17. The December 21, 2005 S&P rating action has placed APS's credit rating in the bottom quartile of all U.S. utilities. APS's borrowing costs have increased $1 million per year as a result of the S&P downgrade to BBB-. The increased costs are as a

result of higher interest rates on commercial paper borrowings and increased bank facility costs. In addition, APS will incur an incremental 10-50 basis points or $100,000 to $500,000 in additional interest costs per year for each $100 million of long-term borrowing that is needed. Further, the downgrade has imposed onerous restrictions on the Company's ability to access funds needed for its construction program.

Potential Future Adverse Credit Rating Actions

18. Absent emergency interim rate relief, as requested in the Application, I believe that APS likely will be further downgraded to non-investment grade, "junk bond" status. Such a negative rating action will result in dramatic negative impacts to APS and its customers.

19 Once a utility is rated below investment grade, financing alternatives become extremely limited and the costs are exorbitant. In addition, at times the market for non-investment grade debt, the so-called "high-yield" or "junk bond" market, is closed for indefinite periods of time. If APS were to fall to a "junk" credit rating, there is absolutely no reason to have any confidence that APS could successfully issue the billions of dollars of "junk" bonds that would be required over the next ten years.

20. Any further degradation in APS's credit ratings from its current BBB- rating to below investment grade would cause an immediate additional annual increase in interest expense in the range of $10 million to $15 million. The amount of additional annual interest expense would grow to $115 million to $230 million by 2015. On a cumulative basis, this translates to an additional $625 million to $1.2 billion in interest expense between 2006 and 2015 — an increase that eventually would be passed onto customers. (The ranges of additional interest expense reflect estimated financing costs calculated using the upper and lower limits of historical interest rates for non-investment grade utility debt financings.) The impact of a downgrading from APS's current credit rating to non-investment grade would be costly on the following fronts:

a. Over the next ten years APS will need to issue almost $5 billion of additional long-term debt to finance essential generation, environmental control, transmission and distribution construction programs and to refinance existing long-term debt as it matures. APS would have no alternative but to turn to the "junk" bond market to finance this capital need. As a result, by 2015, the Company's annual financing costs that are recoverable from customers would increase between $110 million and $225 million over what they would have been if APS had not suffered the credit ratings downgrade to "junk" status.

b. APS has $539 million of tax-exempt debt outstanding under remarketing programs whereby the securities are effectively issued with a daily or weekly maturity, with the intention that the securities will be continuously remarketed until their ultimate maturities in 2024 through 2034. The annual interest rate on this debt currently is in the 3.0% area. Thus, the Company currently is able to take advantage of extremely attractive short-term, tax-exempt interest rates, under the "umbrella" of a very long-term debt instrument. This debt requires bank letters of credit ("LOCs") or insurance to support its creditworthiness. The LOCs and insurance pricing are based on APS's credit ratings. Any further degradation in the ratings would increase such costs. Additionally, the investors would require a higher yield due to the increased risk associated with the lower ratings. The increased fees and additional interest would increase financing costs an additional $4 million per year that would need to be recovered from customers.

c. Given the seasonal nature of APS's cash flows, there is a heavy reliance on commercial paper for working capital needs. APS expects to average about

$200 million of commercial paper outstanding and could face peak liquidity needs of up to $400 million. As a result of the recent downgrade by S&P, APS's access to the commercial paper markets has been extremely curtailed. APS's commercial paper rating is currently A-3 and P-2 by S&P and Moody's, respectively. There is a significant investor base whose investment policies prohibit investments in "Third Tier" (A-3) paper. Given that limited investor base, APS can no longer count on daily liquidity and, at best, can borrow up to one week, whereas typically commercial paper can be issued up to one year. If APS were further downgraded to non-investment grade, its access to the commercial paper market would be <u>eliminated</u>. At a non-investment grade ratings level, there are <u>no</u> investors for commercial paper. Thus, the daily liquidity that the commercial paper market offers would be lost. Rather than taking advantage of the daily flexibility afforded by the commercial paper markets, APS would be forced to turn to its more costly revolving credit agreement to satisfy its daily working capital needs. Such a situation would increase APS's overall cost of borrowing by about $1 million per year, ultimately leading to increased costs for APS's customers.

21. A credit rating downgrade to "junk" would bring about additional negative impacts that, while difficult to quantify, carry the following additional costs and risks:

i. APS places significant reliance on bank credit agreements that are subject to renewal on a periodic basis. The non-investment grade credit rating and forecasted weak cash flow and financial metrics, along with the unsupportive regulatory environment, would cause most banks to "run for the hills" when the credit agreements were up for renewal. The few banks that might renew would charge significantly higher prices and would add extremely onerous covenants that, in the event of further financial stress, could potentially take APS to the brink of default and bankruptcy.

ii. APS's marketing and trading function would suffer as a result of the downgrade of APS to a non-investment grade rating. As is typical in the energy trading business, most of APS's agreements with energy trading counterparties require, in the event of a downgrade that would take APS's credit rating below investment grade, that APS provide the counterparty with cash collateral to cover the difference between the contract price and the then-existing market price of the commodity. These contractual provisions are referred to as "collateral calls." This could place a significant liquidity strain on APS at a time when the Company is least able to access the markets.

iii. In addition to cash collateral calls, energy trading counterparties place other onerous terms on their dealings with non-investment grade companies. APS would be forced to prepay for a large amount of the Company's power plant fuel needs. Any form of longer-term commodity agreement would require the Company to provide up-front cash collateral. APS's costs of doing business in the wholesale markets would increase significantly and make it much more difficult to hedge the Company's commodity positions, further increasing the Company's risk profile.

The $776.2 Million "Cap" on Fuel and Purchased Power

22. In Decision No. 67744, the Commission imposed a $776.2 million "cap" on the amount of fuel and purchased power costs that the Company may pass through to customers. As a result of the recent and dramatic increases in fuel and purchased power costs, the Company will hit that "cap" later this year, far sooner than anyone had anticipated.

23. Unless a decision is reached in APS's pending rate case, Docket No. E-01345A-05-0816, before year end 2006 that permanently lifts that cap, APS will be forced to forgo recovery of over $65 million in costs that were prudently incurred to provide service to its customers. Such an event would further increase the risk that APS would be downgraded to non-investment grade.

This concludes my affidavit.

State of Arizona)
) **ss.**
County of Maricopa)

I, Donald E. Brandt, having been first duly sworn, state that I have read the foregoing affidavit and that the same is true and correct to the best of my knowledge, information and belief.

Donald E. Brandt

Subscribed and sworn before me this 6th day of January, 2006

Notary Public

OFFICIAL SEAL
NORANN ASCIUTTO
Notary Public - State of Arizona
MARICOPA COUNTY
My comm. expires Feb. 12, 2006

ADJUSTMENT SCHEDULE IR-1
INTERIM RATE ADJUSTMENT

APPLICATION

The Interim Rate Adjustment ("IR-1") charge shall apply to all Standard Offer retail electric schedules, with the exception of Rate Schedules Solar-1, Solar-2, SP-1, and E-36. All provisions of the customer's current applicable rate schedule will apply in addition to this charge.

INTERIM ADJUSTMENT

In accordance with A.C.C. Decision No. XXXX, an interim rate adjustment will be made through the IR-1 charge. The adjustment will be applied to all kilowatthour sales under applicable electric schedules.

RATE

The charge shall be calculated at the following rate:

IR-1 Charge

All kWh	\$0.011161	per kWh

The following language shall be inserted as a separate paragraph in the "Adjustments" section of all applicable rate schedules:

"The bill is subject to the Interim Rate Adjustment factor as set forth in the Company's Rate Schedule IR-1 pursuant to Arizona Corporation Commission Decision No. XXXXX."

Rate schedules to be revised are as follows:

E-10
E-12
EC-1
ECT-1R
ET-1
E-20
E-21
E-22
E-23
E-24
E-30
E-32
E-32TOU
E-34
E-35
E-38
E-38-8T
E-40
E-47
E-51
E-52
E-55
E-58
E-59
E-67
E-221
E-221-8T